COMMONWEALTH OF MASSACHUSETTS

DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

Investigation by the Department on its own Motion into the Appropriate Regulatory Plan to succeed Price Cap Regulation for Verizon New England, Inc. d/b/a Verizon Massachusetts' intrastate retail telecommunications services in the Commonwealth of Massachusetts	)	D.T.E. 01-31

RESPONSE OF VERIZON MASSACHUSETTS
ON COMMENTS ON SCOPE OF PROCEEDING

Verizon Massachusetts ("Verizon MA") is responding to the comments filed by intervenors relating to the scope of this proceeding.[1] Verizon MA's proposed alternative regulatory plan ("Plan") is the next step in the evolution of regulation of the telecommunications industry in Massachusetts. The Department's policies since 1984 have expressly and consistently sought to promote competition in the telecommunications market and substitute competitive market forces for pervasive rate regulation. The Plan reflects the existence of a vibrant competitive market and inquiries into that issue are within the scope of this proceeding. Intervenor requests to enlarge the scope of the case to include irrelevant inquiries into revenue requirements, cost allocation, price floors, *etc.*, are incompatible with the issues raised by the Department's *Vote and Order* opening this case and divert attention from the issues relevant to an investigation of the Plan. Transforming an inquiry of this alternative regulatory plan into a

[1] The Attorney General of the Commonwealth ("Attorney General"), AT&T Communications of New England, Inc. ("AT&T"), Network Plus, Inc. and Allegiance Telecom of Massachusetts, Inc. ("Network Plus/Allegiance") and WorldCom, Inc. ("WorldCom") filed comments on scope on May 23, 2001.

traditional rate case, or a vehicle for competitors to present their wish-lists for further hampering Verizon MA's effort to compete in the market, does not serve the legitimate interests of Massachusetts consumers.

I. THE INITIAL FILING

As recognized in some of the comments submitted by intervenors, the Department's long-standing regulatory policy has been predicated on substituting competitive market forces for government intervention. *IntraLATA Competition,* D.P.U. 1731, at 67-68 (1985); *NYNEX*, D.P.U. 94-50, at 113-114, 161 n.95 (1995). As the Department has reiterated on numerous occasions, the purpose of regulation is to replicate the outcome of a competitive market when market forces are not sufficient. *Gas Transportation*, D.P.U. 85-178, at 10 (1987); D.P.U. 94-50, at 161 n. 95.

Over the past two decades, the Department has repeatedly relied on market forces and has identified markets or service providers that need not be subject to traditional forms of regulation. In the telecommunications industry, for example, it created a comprehensive system that relieved non-dominant carriers from all regulation and permitted market-based pricing for services of monopoly carriers that were subject to competitive market forces. D.P.U. 1731, at 55-70. In 1985, all telecommunications carriers except Verizon MA and AT&T were relieved of any form of economic rate regulation.[2] *Id.* In 1992, AT&T was permitted to price most of its intrastate services at market-based rates, with reduced regulatory oversight for its remaining services. *AT&T Communications of New England, Inc.*, D.P.U. 91-79 (1992), at 31-36. Certification of

[2] In accordance with statutory requirements, all carriers must file tariffs of rates and charges with the Department. G.L. c. 159, § 19. *NYNEX*, D.P.U. 96-106, at 60-61 (1997); *AT&T*, D.P.U. 91-79, at 13; *see also* 220 C.M.R. 5.00.

carriers was eliminated in 1994. D.P.U. 93-98. AT&T was relieved of all economic regulation in 1996. *AT&T Communications of New England*, D.P.U. 95-131 at 9 (1996).

Verizon MA is the only remaining carrier pervasively regulated in the Commonwealth. In 1995, the Department approved an alternative regulation plan that subjected Verizon MA to a price-cap regime. *Alternative Regulation,* D.P.U. 94-50 (1995). Although the price-cap plan incorporated some pricing flexibility in recognition of the increased level of competition in the telecommunications industry, the Department recognized that the formula-driven plan was not "deregulation" but simply "another way for regulators to control the rates charged by a firm." *Id*. at 113.

After a comprehensive review of Verizon MA's Section 271 application, the Department and the Federal Communications Commission have determined that the last bastion of intrastate monopoly service, local exchange service, is now "irreversibly open to competition." *Evaluation of the Massachusetts Department of Telecommunications and Energy* (October 16, 2000), CC Docket 00-176; 2001 FCC LEXIS 2117 (April 16, 2001). It is against this backdrop that the Department must consider Verizon MA's proposal in this case and the scope of the proceeding.

In its initial filing, Verizon MA provided a comprehensive description of the competitive marketplace in Massachusetts and explained why the proposed Plan is appropriate. Mr. Mudge's testimony presents an overview of the Plan and describes the three types of competition for local markets, *i.e.*, resale, unbundled network elements, and facilities-based service. Ms. Brown's testimony describes the details of the Plan and how it meets the Department's policy objectives in the context of vibrant competition in the marketplace. Dr. Taylor places into economic perspective how consumers in the competitive marketplace for telecommunications services in Massachusetts would best be served by the implementation of the Plan.

Because competition is relevant to the Plan, Verizon MA agrees with those comments that competitive conditions in Massachusetts are within the scope of the Department's review in this case.[3] However, as described below, the intervenors' request that the scope be enlarged to include irrelevant inquiries into revenue requirements, cost-allocation, price floors, and other mechanisms to constrain Verizon MA's market behavior and competitive success are incompatible with the issues raised by the Department's *Vote and Order* opening the case and the proposed Plan.

II. RESPONSE TO INTERVENOR COMMENTS

A. The Attorney General

The Attorney General's comments focus on the Department's statutory role of determining "reasonable" rates for telecommunications services. Citing the price-cap proceeding, D.P.U. 94-50, the Attorney General implies that to fulfill its statutory mandate the Department must determine whether the Company's current rates are just and reasonable based on Verizon MA's costs to provide service (Attorney General Comments, at 5-6). The Attorney General states that the Department must conduct a traditional revenue requirement and rate structure investigation, including a fully allocated cost of service study, "to determine the Company's actual earnings and set appropriate rates for the future" (*id.* at 7). The Attorney General has misconstrued the Company's proposal as well as the investigation conducted in D.P.U. 94-50.

In the price-cap case in 1995, the Department correctly noted that price-caps represented an improvement for a rate-of-return regulated company. D.P.U. 94-50, at 113-115. It was not a

[3] In that regard, the Plan is designed to permit maximum pricing flexibility where competitive market forces are strongest (business services) with pricing restrictions for arguably a less competitive market (basic residential services) and continued service-quality protections for all customers.

case, however, in which market forces were being proposed as a substitute for Department rate regulation. Verizon MA's rates at the outset of the plan were to be adjusted by a formula over the life of the plan, and consequently, the reasonableness of those initial rates was an appropriate subject of review. The earnings review that the Department conducted was designed to ensure that those starting rates did not reflect an excess level of return for Verizon MA, since those rates would serve as the basis for the rates in effect for six years. D.P.U. 94-50, at 273. In contrast, this case does not require a similar level of review of existing rates or earnings.

The rates in effect today reflect the starting rates found reasonable by the Department that have changed only in accordance with the pricing rules of the price-cap plan. Since the current rates are the product of the form of regulation adopted by the Department set through annual compliance filings under the Department's pricing rules, the current rates are presumptively "just and reasonable." As the Department recently explained: "[B]ecause the Price Cap Plan is designed so that any rate changes that are in compliance with the pricing rules will result in just and reasonable rates, compliance with the pricing rules will be considered evidence of the propriety of the proposed rate changes . . . . Compliance with the pricing rules is prima facie evidence of their reasonableness." D.T.E. 99-102, at 16-17 (2000).

Equally important, however, Verizon MA's proposed Plan reflects the fact that competitive markets exist in the telecommunications industry in Massachusetts, and that those competitive forces will ensure a continuation of just and reasonable rates under the Plan. The Plan asks for approval of market-based pricing for all business services, with rate caps for basic residential services. A time-consuming, resource-intensive revenue-requirement/cost allocation investigation to prescribe rates is fundamentally inconsistent with the price-cap form of regulation under which Verizon MA has been under and with the proposed Plan, which would

permit certain rates to change based on market conditions. Absent a return to cost-of-service, rate-of-return regulation, there is no justification to warrant a full-blown, traditional rate case, as suggested by the Attorney General.

The Attorney General also argues that, in this case, the Department must examine "market conditions and existing competition in Massachusetts" and that the Company must demonstrate that the elimination of price-cap regulation is in the public interest (Attorney General Comments, at 7-8). Verizon MA does not agree with the Attorney General regarding the level of detail that the Department must consider in determining that competition will effectively ensure the continuation of just and reasonable rates for telecommunications services in Massachusetts. However, Verizon MA agrees that evidence of market conditions that warrant the elimination of traditional monopoly regulation of its prices, and why such change is in the public interest, are relevant to this proceeding.

Finally, the Attorney General urges the Department to consider alternatives to the Plan proposed by Verizon MA in this proceeding (*id.* at 8). Again, the Company believes that the Plan is in the public interest and is a reasonable response to the competitive nature of the telecommunications market in Massachusetts. Nonetheless, Verizon MA understands that other parties in this case will have the opportunity to present their views and proposals consistent with the *Vote and Order* for the Department's consideration.

B. AT&T

AT&T's comments contain an extensive history of the evolution of the regulatory restrictions placed on Verizon MA since the Bell System divestiture. Verizon MA does not agree with all of the characterizations contained in that recitation, but three aspects are noteworthy. The first is that the degree of economic regulation imposed by the Department is inversely proportional to the degree of competition existing in the marketplace (AT&T Comments, at 2-9).

Although there may be disagreement as to the competitiveness of the Massachusetts' telecommunications market, Verizon MA does not disagree that competition is at issue in this case.[4]

The second issue raised in AT&T's historical review is the role of price floors in the determination of retail rates in Massachusetts (AT&T Comments, at 9-13). AT&T contends that the Department has failed to rule substantively on AT&T's proposal to establish an imputation-based price floor, and that the Department should include a review of such a price floor in the scope of this proceeding (AT&T Comments, at 9-13; 20-23). AT&T's contention is without merit.

The Department has previously given full consideration to AT&T's suggested approach to price floors and firmly rejected it.[5] The Department determined that the presence of wholesale tariffs for all services eliminates the possibility of price squeezes, since competitors are able to purchase any retail service at a discounted rate. *Order on AT&T's Motion for Reconsideration of D.P.U./D.T.E. 94-195-C, and the Department's Question of Whether To Establish Wholesale Price Floors*, D.P.U./D.T.E. 94-185-D, at 9 (1998).[6] On reconsideration, the Department stated:

> In response to AT&T's Motion for Reconsideration, we reconfirm that a wholesale tariff satisfies [Verizon MA]'s obligation to set retail price floors. [AT&T's expert witness] presented no information that had not previously been before the Department and would have a significant impact on a decision already rendered.

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[4] The specific standard of review and the necessary Department findings that must be made will be the subject of the hearings and final briefing.

[5] AT&T's disagreement with the outcome of a series of cases before the Department has no bearing on the scope of this case.

[6] As the Department noted, this determination was consistent with Department precedent. In D.P.U. 94-50, the Department contemplated using wholesale rates to ensure competition for services. D.P.U.94-50, at 218 n.120).

D.P.U./D.T.E. 94-185-D, at 9. Thus, the Department approved the use of wholesale prices as the retail price floor in D.P.U. 94-185-B, confirmed its decision in D.T.E. 94-185-C, and "reconfirmed" its holding in D.P.U. 94-185-D. Most recently, the Department approved Verizon MA's compliance filing including revised price floor computations and associated workpapers, consistent with the Department's letter order, dated February 22, 2001 in D.T.E. 94-185-F. In short, the issue of appropriate price floors has been thoroughly reviewed, decided, and confirmed at least four times by the Department. It should not be re-examined here, as AT&T contends.

Indeed, the Plan does not seek any change in the Department's price-floor requirements and explicitly requires that Verizon MA comply with the price-floor rules as they currently exist and may be changed in the future (*see* Plan, at paragraph L). Since the Plan does not attempt to establish price-floor rules in this case and incorporates any changes that may occur in the future, changes in the price-floor rules are not within the scope of this proceeding.

AT&T also "suggests" that the Department adopt a universal service funding mechanism that could be used to offset increases in residential rates (AT&T Comments, at 21-22). AT&T admits that its "suggestion is not intended to be a definitive proposal" (*id*., at 22), but urges the Department to undertake an investigation nonetheless. Whatever doubtful merit there may be for a universal service mechanism, such an investigation would be an enormous undertaking that would require the Department to define and quantify existing "subsidies" in retail rates, consider cost studies and rate-rebalancing proposals, and construct a subsidy program designed to promote universal service. Even assuming that the Department has the statutory authority to order such a system, it would be a daunting task that would need to be undertaken in a separate proceeding. AT&T's "suggestion" is merely an attempt to derail this proceeding by unduly burdening it with complicated and extraneous issues.

AT&T's historical overview of telecommunications regulation in Massachusetts is remarkable in that it does not address the manner in which the Department has relaxed the level of regulation imposed on AT&T in response to changes in the competitive markets. In D.P.U. 1731, the Department determined that AT&T retained market dominance in the intrastate long-distance market and subjected the company to traditional rate-of-return regulation immediately after divestiture. D.P.U. 1731, at 61-62. In 1990, AT&T asked that the Department declare AT&T a "non-dominant" provider and thus be relieved of economic regulation of its prices for intrastate telecommunications services. *AT&T Communications of New England*, D.P.U. 90-133. The Department denied that petition, but AT&T subsequently requested, and was granted, a request to declare a majority of its services as "sufficiently competitive." *AT&T Communications of New England*, D.P.U. 91-79. The Department permitted most of AT&T's services to be priced based on market conditions and not on traditional, administratively-determined rate cases. Finally, in 1995, AT&T petitioned the Department to be relieved of all price regulation and be permitted to set its prices on the basis of market conditions. Without objection from Verizon MA, the only intervenor in the proceeding, the Department granted AT&T's request. *AT&T Communications of New England*, D.P.U. 95-131, at 9 (1996).

AT&T's failure to even mention the most applicable precedent for this proceeding is telling. The history of the evolution of the Department's regulation of AT&T is a parallel to the situation faced by the Department in this proceeding. After initially subjecting AT&T to traditional regulation for all of its intrastate operations, the Department took into account the competitive changes in the toll markets, and in 1992 and 1995, essentially eliminated economic regulation of AT&T, thereby allowing all of AT&T's services to be priced at market-based rates.

For Verizon MA, although competition was permitted in Massachusetts for all local services in 1985, competition grew more slowly. Competition developed in niche markets for local exchange services for several years. However, the advance of technology and the mandates of the 1996 Telecommunications Act greatly accelerated the pace of competition over the past five years. Like AT&T before it, Verizon MA will demonstrate in this proceeding that the evolution of local competition in Massachusetts has reached a stage that justifies market-based pricing.

Despite the recitation of the history of the Department's regulatory policies, AT&T also ignores the Department's oft-stated preference to rely on competitive market forces and, instead, requests that the scope of this proceeding include a complete investigation of Verizon MA's costs, earnings, rate design, and rate structure (AT&T Comments, at 17-20). AT&T cannot have it both ways. AT&T has cited Department precedent that states unequivocally that rate regulation is a second-best replication of the outcome of market forces and is not necessary if a competitive market exists. Like the Attorney General, AT&T's request to expand the scope of this proceeding to include a 1980s-style review of revenue requirements and rate design is inconsistent with a market-based pricing regimen.[7]

[7] The only conceivable purpose for any type of earnings review cited by AT&T is in the context of determining whether Verizon MA has sufficient market power to extract "monopoly profits" (AT&T Comments, at 18). Dr. Taylor puts this notion to rest in his direct testimony (Taylor Direct, at 16). Whatever probative value a review of Verizon MA's earnings may have on the issue of competition, a traditional revenue requirement/earning review would be regulatory overkill. If its existing level of earnings is to be considered in this proceeding, Verizon MA should be required to provide only audited financial reports to demonstrate that its level of earnings is within a "zone of reasonableness" of a firm in a competitive market. Contrary to the assertion of the Attorney General, Verizon MA is not earning a 30 percent return. However, the Company objects to expanding the scope of these proceedings to include the type of earnings review/revenue requirement proceeding that was conducted to determine the reasonableness of the starting rates when the Department adopted its price-cap plan in D.P.U. 94-50.

C. Network Plus/Allegiance

Network Plus/Allegiance's comments largely focus on competitive issues. Verizon MA will not engage in this limited pleading on scope to engage in an extensive substantive response to the issues raised by Network Plus/Allegiance. As described above, the existence of competition in Massachusetts is within scope of this case, and parties will be able to present their evidence and argument on this issue later in the proceeding. A few responses to the Network Plus/Allegiance comments, however, are appropriate.

In the first section of its comments, Network Plus/Allegiance implies that the Department is not legally permitted to rely on competitive market forces to ensure that Verizon MA rates are just and reasonable (Network Plus/Allegiance Comments, at 4-10). Citing precedent of the Federal Power Act, Network Plus/Allegiance contends that the Department is statutorily precluded from approving market-based pricing flexibility. Network Plus/Allegiance has misstated both federal law and its applicability to the Department.

First, the statutes or judicial interpretations of other jurisdictions do not bind the Department. In fact, the Department has interpreted *its* statutory authority under G.L. c. 159 to permit the "just and reasonable" standard to be satisfied by competitive conditions. All telecommunications common carriers, including Verizon MA, AT&T, and Network Plus/Allegiance, are subject to the same statutory provisions, and the Department found in 1985 that market-based rates, not traditional modes of economic regulation, met the statutory standard if justified by competitive market forces. D.P.U. 1731, at 32-33. This finding has been reiterated on numerous occasions when the Department has approved market-based pricing for all telecommunications carriers in the Commonwealth, except for Verizon MA. *AT&T Communications of New England*, D.P.U. 95-131; D.P.U. 94-50 (Interlocutory Order dated February 2, 1995), at 47, citing *First Phone Inc.*, D.P.U. 1581 (1984); *Cellular Resellers*, D.P.U.

84-250-1 (1984); *GTE Sprint Communications Corporation*, D.P.U. 84-157, at 4 (1985). Indeed, if the Department were to adopt the Network Plus/Allegiance suggestion, the Department would be precluded from approving market-based pricing flexibility for all carriers.

Moreover, the federal cases and law cited by Network Plus/Allegiance do not stand for the proposition that market-based pricing is prohibited under federal statute. In fact, both the Federal Communications Commission and the Federal Energy Regulatory Commission have, in numerous instances based on federal law, deregulated prices in markets found to be subject to competitive market forces. *Fifth Report and Order and Further Notice of Proposed Rulemaking in In Re Access Charge Reform*, 14 FCC Rcd 14, 221 (1999), *aff'd, WorldCom, Inc. v. FCC,* 238 F3d 449 (D.C. Cir. 2001); *Motion of AT&T Corp. To Be Declared Non-Dominant for International Service*, 11 FCC Rcd 17,976 (1996), *aff'd, Order on Reconsideration*, 13 FCC Rcd 21,501 (1998); *El Paso Electric* Company, 87 FERC ¶ 61,219 (1999); *New England Power Pool*, 85 FERC ¶ 61,379 (1998); *Louisiana Energy and Power Authority v. FERC*, 141 F.3d 364 (D.C. Cir. 1998); *Southwestern Public Service Company*, 72 FERC ¶ 61,208 (1995); *U.S. Gen. Power Services, L.P.*, 73 FERC ¶ 61,302 (1995).[8]

Network Plus/Allegiance also contends that the Department should consider adopting a number of measures to ensure that Verizon MA does not engage in discriminatory conduct in relation to competitors and establish procedures for addressing complaints by retail customers and CLECs concerning potential improper conduct by Verizon MA (Network Plus/Allegiance Comments, at 16-17). Such safeguards are already in place and do not need to be expanded in the context of this proceeding.

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[8] *See, also* D.P.U. 94-50, *Interlocutory Order on Motion to Dismiss of the New England Cable Television Association, Inc.*, at 33-67 (1995), in which the Department provided an extensive legal analysis relating to the adoption of alternative forms of regulation under its statutory mandate.

The Department actively enforces Verizon MA's obligation to provide competitors with interconnection, unbundled network elements, and resale at rates approved by the Department as required by the Telecommunications Act and at clearly defined service performance levels. To ensure that Verizon MA has adequate financial incentives to continue to meet its obligations to its wholesale customers, the Department and the FCC have approved a Performance Assurance Plan ("PAP"), under which Verizon is required to meet specified performance standards or face up to $155 million per year in financial penalties. The standards track Verizon MA's performance on functions essential to an open, competitive local market: pre-ordering, ordering, provisioning, maintenance and repair, network performance (interconnection trunks), collocation, billing and operator services. *See Application of Verizon New England for Section 271 Authority,* CC Docket No. 01-9, at ¶¶ 237 – 249.

> The PAP sets forth in great detail, the processes by which Verizon's performance is measured and evaluated, the method for determining compliance and noncompliance with respect to individual metrics, and the manner in which noncompliance with individual metrics will translate into bill credits.

Id., at ¶ 245. Accordingly, the PAP provides comprehensive protection against potential anti-competitive behavior and addresses Network Plus/Allegiance's claims.

Similarly, the Department has adopted regulations that provide CLECs with expedited dispute resolution procedures for complaints involving Verizon MA. These rules, found in 220 C.M.R. 15.00 *et seq.*, are designed to facilitate increased competition for telecommunications services by offering prompt resolution of disputes. *Regulations Governing an Expedited Dispute Resolution Process*, D.T.E. 00-39-A (2000). Accordingly, the issues raised by Network Plus/Allegiance relating to competitive safeguards have been resolved in other proceedings and are outside the scope of this case.

Finally, Network Plus/Allegiance raises the issues of an earnings review and price-floor determination as issues that should be considered in this proceeding. For the reasons described above, neither an earnings review nor a reopening of price-floor issues is appropriately within the scope of this case.

D. WorldCom

WorldCom limits its comments on scope to the relationship between retail and wholesale rates established in D.T.E. 01-20 (WorldCom Comments, at 1-2). As stated above, the Plan adopts the existing price-floor requirements of D.P.U. 94-185. Since the Company's wholesale rates are to be established in another proceeding and the Plan requires compliance with all price floor requirements (regardless of the pricing flexibility otherwise envisioned under the terms of the Plan), those issues are not within the scope of this proceeding.

III. CONCLUSION

It comes as no surprise that the intervenors disagree with Verizon MA's views about the competitiveness of the Massachusetts' telecommunications market. But there is no dispute that the Department may consider that issue in order to determine whether the Plan is in the public interest and will continue to give rise to just and reasonable rates. Beyond that, the arguments to expand the scope beyond consideration of the Plan, possible alternatives proposed by other parties and issues relating to competition are without merit. The Department should reject calls

to turn back the clock and conduct a traditional rate case (with full cost of service and cost allocation support), to relitigate the issue of price floors, or to undertake a complex investigation of universal service fund issues in this proceeding.

Respectfully submitted,

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Dated: May 31, 2001